

No. 91-7804

Supreme Court, U.S.

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In the Supreme Court of the United States

OCTOBER TERM, 1992

SHELDON B. BUFFERD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether, when a loss and an investment tax credit are erroneously reported on the return of a Subchapter S corporation, and those items "pass through" to the return of a shareholder (with whom an extension of the period of limitation has been duly executed), they may be disallowed on the shareholder's return *after* the limitations period for assessing tax against the corporation has expired.

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OPINIONS BELOW

The opinion of the court of appeals (J.A. 66-74) is reported at 952 F.2d 675. The opinion of the Tax Court (J.A. 57-61) is reported unofficially at 61 T.C.M. (CCH) 2410.

JURISDICTION

The judgment of the court of appeals was entered on January 3, 1992. The petition for a writ of certiorari was filed on March 10, 1992, and was granted on June 22, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. In 1979, petitioner was a shareholder of a qualified small business corporation known as Compo Financial Services, Inc. Under the provisions of Subchapter S of the Internal Revenue Code, items of income, loss and tax credits of a qualified small business corporation ordinarily "pass through" to the shareholders of the corporation and are reported on their individual income tax returns. See 26 U.S.C. 1366(a)-(c);¹ 3 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 95.6, at 95-89 to 95-114 (1991). The Subchapter S corporation is itself directly liable for tax in only a few, limited circumstances not involved in this case.² When items

¹ During the period involved in this case, the Subchapter S provisions were located at 26 U.S.C. 1371 *et seq.* (1976). These provisions were modified and renumbered as 26 U.S.C. 1361 *et seq.* by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669. The modification and re-enactment of the Subchapter S provisions in 1982 did not affect the issue presented in this case.

² During the period relevant to this suit, a Subchapter S corporation was itself liable for tax only in limited circumstances. It was subject to a special tax imposed on certain of its long-term capital gains under 26 U.S.C. 1378 (1976). Such gains also could generate a "minimum tax" on the corporation under Sections 56 and 58(c) (2) as then in effect. See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 6.07, at 6-22 to 6-25 (5th ed. 1987). Otherwise, however, so long as the corporation preserved its Subchapter S status, it was exempt from the regular income tax imposed on other corporations by Section 11, and its gains, losses, and credits were apportioned to its shareholders according to their respective stock interests. In that respect, the "pass through" treatment afforded a Subchapter S corporation and its shareholders resembles the treatment historically afforded to a partnership and its partners. See *United States v. Basye*, 410 U.S. 441, 448 n.8 (1973).

"pass through" to the shareholders, it is the shareholders (rather than the corporation) whose tax is affected by disallowance of erroneous items derived from the Subchapter S corporation. See *ibid.*

Under Section 6037 of the Code, Subchapter S corporations are required to file annual income tax returns that serve both (i) as "information returns," providing detailed information on income and deductions for the preparation of individual shareholder returns and (ii) as corporate returns in the limited situations when the corporation is itself liable for tax (see note 2, *supra*). See *Fehlhaber v. Commissioner*, 954 F.2d 653, 655 (11th Cir. 1992). Pursuant to Section 6037, the Subchapter S corporation (Compo) of which petitioner was a shareholder filed its 1979 return on February 1, 1980 (J.A. 38). On that return, Compo reported an erroneous loss deduction and tax credit that "passed through" to Compo's shareholders.³ Petitioner reported his share of the erroneous loss and credit on his individual income tax return for 1979, which he filed on April 15, 1980 (J.A. 12, 14-15).

b. Section 6501(a) of the Internal Revenue Code generally requires that any assessment of income taxes be made by the Internal Revenue Service "within 3 years after the return was filed." 26 U.S.C. 6501(a).⁴ This three-year limitations period may be

³ Compo was a partner in a partnership named Printer Associates. The erroneous loss deduction and tax credit that Compo reported resulted from its participation in that partnership. See J.A. 14-15, 40.

⁴ Section 6501(a) provides:

Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed

extended by a written agreement signed by the Service and the taxpayer before the period expires. 26 U.S.C. 6501(c)(4). If the Service mails a notice of deficiency to a taxpayer while the assessment period is still open (by virtue of such an extension or otherwise), the time for assessment is tolled, and if the taxpayer timely seeks review of the deficiency in the Tax Court, the assessment period stays open until after the Tax Court's decision becomes final. 26 U.S.C. 6503(a)(1).

In March 1983, before the three-year period for assessing petitioner's 1979 taxes expired, petitioner and the Internal Revenue Service signed a consent to extend the period for assessment in accordance with Section 6501(c)(4) (J.A. 55-56).⁵ In December 1987,

within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

⁵ The extension agreement applied, by its terms, to adjustments relating to "any partnership (or any organization treated by the taxpayer as a partnership on the taxpayer's tax return)" (J.A. 55-56). Presumably because the deficiency at issue (both currently and at the time the extension agreement was made) concerns Compo's treatment of partnership items (see note 3, *supra*), petitioner stipulated that the deficiency notice was timely under the extension agreement (J.A. 15). Petitioner did not contend in the Tax Court that the extension agreement was inapplicable to the partnership items reflected on Compo's and petitioner's returns. Petitioner also declined to raise such a contention in the court of appeals, "even after a request for additional briefing" on that issue

within the period so extended, the Service mailed petitioner a notice of deficiency. The notice asserted a deficiency in petitioner's individual income tax for 1979 based upon disallowance of his distributive share of the erroneous loss deduction and tax credit reported by Compo (J.A. 15-16).

2. Petitioner filed a timely Tax Court petition for review of the deficiency (J.A. 2-8). While not disputing that the assessment period applicable to his individual tax return remained open due to his extension agreement and petition to the Tax Court, petitioner claimed that the disallowance of the "pass through" items from the Subchapter S corporation was time-barred because the period for assessing a tax against that corporation had lapsed (J.A. 7).

Petitioner's contention was based upon Section 6037(a) of the Code, which provides that the statute of limitations for a return filed by a Subchapter S corporation is the same as for a return filed by an ordinary business corporation under Section 6012 of the Code. See 26 U.S.C. 6037(a). The return of Compo Financial for the period ending November 30, 1979, was filed on February 1, 1980 (J.A. 13-38). Because the adjustments to the erroneous deduction and tax credit that "passed through" to petitioner in this case did not create any tax liability for the Subchapter S corporation, and since that corporation was not liable for petitioner's individual income tax deficiencies resulting from inclusion of the erroneous Subchapter S corporation deductions and tax credits, the Service did not seek an extension of the limita-

tion was made by that court (J.A. 74). Since petitioner raised no objection, the court deemed the extension agreement "applicable to the income at issue here" (J.A. 73-74).

tions period for assessing taxes against the corporation for 1979. The three-year period for making an assessment against the corporation for any taxes it owed under its 1979 return thus expired in February 1983, before the Service mailed a notice of deficiency to petitioner.

The Tax Court concluded that the period for assessing the deficiency in petitioner's taxes had not expired (J.A. 57-61). The court held that the period during which taxes may be assessed under Section 6501 "is measured with reference to the individual shareholder's income tax return, rather than the [Subchapter S] corporation's information return" (J.A. 61). In so ruling, the court followed its unanimous, reviewed decision in *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990), aff'd, 954 F.2d 653 (11th Cir. 1992). The Tax Court acknowledged that its decisions in *Fehlhaber* and in this case were in conflict with *Kelley v. Commissioner*, 877 F.2d 756 (1989), where the Ninth Circuit held that "pass through" items from a Subchapter S corporation could not be disallowed on the return of an individual shareholder *after* the time for assessing tax against the corporation had expired. The Tax Court concluded that *Kelley* was wrongly decided and declined to apply it in cases not appealable to the Ninth Circuit (J.A. 61).

3. The Second Circuit affirmed (J.A. 66-74). The court of appeals concluded that, under the "clear and unambiguous" language of the statute, "[t]he relevant return for purposes of [S]ection 6501(a) is [petitioner's] return rather than Compo's S corporation return" (J.A. 72, 73). In the court's view, Sections 6037 and 6501 created no impediment to assessing petitioner for his personal tax deficiency produced by adjustments to his share of "pass through" items

derived from the Subchapter S corporation's return. The court explained that "[a]n adjustment to the return of an S corporation that does not impose tax liability on that S corporation is not barred by [S]ections 6501(a) and 6037" (J.A. 71). For this reason, the court of appeals expressly "disagree[d]" with the contrary decision of the Ninth Circuit in *Kelley* (*ibid.*).

SUMMARY OF ARGUMENT

Section 6501(a) of the Internal Revenue Code provides that "the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed." 26 U.S.C. 6501(a). Under the plain language of this statute, an assessment against a given taxpayer is not barred unless it is made more than three years after the filing of "the return" of the taxpayer against whom the tax is assessed. Since the taxes resulting from the income and deductions that "flow through" to the shareholder of a Subchapter S corporation are owed by the shareholder, and not by the corporation, the period for assessing the shareholder's taxes runs from the filing of *his* return. Before that period expired in this case, petitioner agreed to extend it in accordance with Section 6501(c)(4) of the Code. The notice of deficiency was mailed to petitioner within the period so extended and, therefore, within the time allowed by the statute.

It is irrelevant that the three-year period for assessing taxes that might be owed by the Subchapter S corporation had expired before the deficiency notice was issued to petitioner. The Subchapter S corporation is not itself liable for taxes on the income and deductions that "pass through" to its shareholders;

only the shareholders are liable for taxes on these items. Accordingly, there was no tax liability to be assessed on the corporation. Moreover, the income tax return of the Subchapter S corporation obviously does not contain sufficient information to compute the shareholders' tax liabilities, which depend not only on the "pass through" items from the Subchapter S corporation but also on income, deductions, and exemptions attributable to other sources.

The court of appeals correctly rejected petitioner's contention that Section 6037 of the Code requires a different conclusion. Under Section 6037, a Subchapter S corporation is required to file a return each year reporting the items that "pass through" to its shareholders and also reporting its tax liability in the limited situations when it is directly liable for tax. When the Subchapter S corporation is itself liable for tax, the period for assessing tax against the Subchapter S corporation runs from the date that its return is filed. Because the erroneous losses and credits reported by the Subchapter S corporation "pass through" to its shareholders, however, it is the shareholders—not the Subchapter S corporation—who are liable for taxes resulting from disallowance of the erroneous items. It is thus from the date that the shareholders' returns are filed—not the date that the corporation's return was filed—that the limitations period for assessment against the shareholders runs under Section 6501(a).

ARGUMENT

ERRORS IN REPORTING ITEMS OF INCOME ON THE RETURN OF A SUBCHAPTER S CORPORATION THAT "PASS THROUGH" TO THE RETURNS OF INDIVIDUAL SHAREHOLDERS MAY BE DISALLOWED ON THE SHAREHOLDERS' RETURNS REGARDLESS OF WHETHER THE LIMITATIONS PERIOD FOR ASSESSING TAX AGAINST THE CORPORATION HAS EXPIRED

Upon examination of petitioner's return, the Internal Revenue Service disallowed an erroneous loss deduction and tax credit that petitioner had claimed. The erroneous deduction and credit stemmed from the business conducted by a Subchapter S corporation. The Subchapter S corporation was not itself subject to tax on these items, which "passed through" directly to the individual returns of its shareholders, including petitioner. See pages 2-3, *supra*. Petitioner does not attempt to defend the erroneous deductions and credits and thus does not contest the merits of the proposed adjustments.

Instead, petitioner asserts that any assessment of the resulting deficiency in his taxes is barred by the statute of limitations because the period for assessing a tax against the Subchapter S corporation (which was not subject to tax on these items) had expired. In an opinion whose holding has since been joined by the Eleventh Circuit in *Fehlhaber v. Commissioner*, 954 F.2d 653 (1992), and by the Fifth Circuit in *Green v. Commissioner*, 963 F.2d 783 (1992), the court of appeals correctly concluded that expiration of the period for assessing tax against a Subchapter S corporation does not bar adjustment of the items of income or loss that "pass through" directly to the returns of the individual shareholders. The Commis-

sioner is therefore not barred from assessing the tax deficiency against petitioner in this case.

A. Under Section 6501 of the Internal Revenue Code, the Statute of Limitations for the Assessment of Income Taxes Commences Upon the Filing of "The Return" of the Taxpayer on Whom the Tax Is Imposed

1. The Commissioner of Internal Revenue is authorized to examine the return of every taxpayer to determine his "taxable income" (26 U.S.C. 1, 11) and to ensure the correct calculation of taxes due. See 26 U.S.C. 7601. If that examination reveals that additional taxes are owed, the Commissioner is to issue a "notice of deficiency" to the taxpayer and, ultimately, to enter an "assessment" of the taxes owed.⁶ Once an "assessment" of the tax liability is made, the Commissioner may commence administrative and judicial procedures to collect the taxes due.⁷ Section 6501(a) of the Internal Revenue Code provides, however, that "the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed" and that "no proceeding in court without assessment for the collection of such tax shall

⁶ See 26 U.S.C. 6212(a) (notice of deficiency to be issued if a deficiency is determined), 6213(a) (assessment to be made after time to seek Tax Court review of notice of deficiency has expired or the Tax Court decision becomes final), 6215 (assessment of deficiency found by Tax Court). An "assessment" is made "by recording the liability of the taxpayer in the office of the Secretary" (26 U.S.C. 6203).

⁷ See 26 U.S.C. 6303 (notice and demand for payment after assessment), 6321-6322 (lien for taxes arises after assessment), 6331 (administrative levy on property to collect taxes unpaid after demand following assessment), 7403 (civil action to enforce lien); 28 U.S.C. 1396 (civil action for collection of unpaid taxes).

be begun after the expiration of such period." 26 U.S.C. 6501(a).

The statute of limitations contained in Section 6501(a), by its terms, limits the time in which the Commissioner may make a valid assessment of taxes. But it does not operate to bar the Commissioner from making a correct determination of the taxpayer's "taxable income" *within the period provided*. In particular, in examining a return for the purpose of ensuring that it properly sets forth the taxpayer's "taxable income," the Commissioner is not required to accept the taxpayer's characterization of items of income or loss merely because those same items were characterized in the same manner on some other return (of the same or a different taxpayer) that is no longer subject to assessment. Section 1312 of the Code expressly recognizes that, in examining a current return, the Commissioner may determine that an item is to be included as income (or a deduction is to be denied) on that return *even though* that item was erroneously included as income (or was erroneously not claimed as a deduction) on a prior return of the taxpayer or a third party for whom the statute of limitations has expired. 26 U.S.C. 1312(1) and (4).⁸ See also *Commissioner v. Munter*, 331 U.S. 210

⁸ The Code recognizes that these and other similar adjustments could result in an unfair double tax if an item of income is found subject to tax on the current return and the prior return, on which the same item was erroneously reported as income, is no longer subject to correction. Sections 1311-1314, which are referred to as the "mitigation" provisions of the Code, alleviate the potential double tax that can occur when the error is corrected after "the ordinary period of limitations has run for [the earlier] year." M. Saltzman, *IRS Practice and Procedure* ¶ 5.07, at 5-33 (1981). In the present case, the disallowance of the improper deduc-

(1947) (shareholder's return adjusted to reflect item as dividend, rather than return of capital, based upon recalculation of corporation's accumulated earnings and profits); *Bull v. United States*, 295 U.S. 247, 252 (1935) (income tax recovered by Commissioner on items erroneously reported as subject to estate tax, even though the estate had paid the tax and the statute of limitations had expired on estate tax refund; estate permitted a credit for overpayment of estate tax against income tax found due); *Commissioner v. Goldwyn*, 175 F.2d 641 (9th Cir. 1949). See note 8, *supra*. As the court stated in *Leonhart v. Commissioner*, 414 F.2d 749 (4th Cir. 1969), errors in the return of a Subchapter S corporation do not justify a shareholder's failure to report and pay the proper tax on his income: the shareholder "can and should pay the amount of tax he owes on an accurate report of [his share of] corporate income." *Id.* at 750.

Since the statute of limitations on the "assessment" of taxes does not bar the Commissioner from making a correct determination of petitioner's "taxable income" within the time provided, the statute does not bar the assessment in this case. Under the plain language of the statute, an assessment is not barred unless it is made more than three years after the

tion and credit on petitioner's return does not result in a double tax, for only petitioner is subject to tax on these items (since the Subchapter S corporation is not itself subject to tax). See page 2, *supra*. The "mitigation" provisions of the Code thus have no direct application to the tax at issue in this case.

For the same reasons, the doctrines of estoppel and set off are not applicable to this case. See M. Saltzman, *supra*, ¶ 5.06, at 5-26 to 5-31. These doctrines have potential application only when the Commissioner, "by using the statute of limitations, attempts to profit by inconsistency." *Id.* at 5-27.

filing of "the return" of the taxpayer against whom the tax is "imposed" (26 U.S.C. 6501(a)). See *Siben v. Commissioner*, 930 F.2d 1034, 1035 (2d Cir.), cert. denied, 112 S. Ct. 429 (1991). The tax in this case is "imposed" on petitioner, not on the Subchapter S corporation of which he is a shareholder. Indeed, no tax is imposed on the Subchapter S corporation, regardless of the erroneous loss deduction and tax credit that the corporation reported.⁹ See 26 U.S.C. 1366(a)-(c); notes 2, 8, *supra*. The notice of deficiency reflecting the adjustments in petitioner's return was mailed within the period provided by Section 6501(a), as extended by agreement pursuant to Section 6501(c)(4) (J.A. 15, 74).¹⁰ The court of appeals therefore correctly con-

⁹ Since the Subchapter S corporation is not the "taxpayer" whose "liability" is to be recorded "in the office of the Secretary" (26 U.S.C. 6203), there was no assessment to be entered on that corporation.

¹⁰ In his brief on the merits in this Court (Br. 10), petitioner now contends for the first time that his agreement to extend the statute of limitations—which, by its terms, refers to adjustments in "partnership" items (J.A. 14, 74)—should not be interpreted to apply to adjustments to items relating to the Subchapter S corporation. As we have noted, petitioner did not raise this claim in either the Tax Court or the court of appeals. See note 5, *supra*. Indeed, petitioner declined to press such a contention in the court of appeals even after the court requested additional briefing from the parties on this very point (J.A. 74). Based upon petitioner's continued failure to assert such a claim, the court of appeals deemed the extension agreement applicable to adjustment of the items involved in this case (*ibid.*). This conclusion was especially appropriate since the deficiency at issue in this case arose from Compo's erroneous treatment of partnership items. See note 5, *supra*. In his petition for a writ of certiorari, petitioner also did not raise or address the claim that he now seeks to assert in his merits brief. In these circum-

cluded that the assessment of petitioner's taxes is not barred by the statute of limitations.

2. Petitioner nonetheless contends (Br. 14-15) that when a deficiency is attributable to an item that is "passed through" to an individual's return from a Subchapter S corporation, the relevant "return" that commences the running of the statute of limitations under Section 6501(a) should be the "return" of the corporation, rather than petitioner's individual return. That contention lacks any foundation.

Statutes of limitation that bar "the collection of taxes otherwise due and unpaid are strictly construed in favor of the Government." *Badaracco v. Commissioner*, 464 U.S. 386, 392 (1984) (quoting *Lucia v. United States*, 474 F.2d 565, 570 (5th Cir. 1973)). The income tax "return" referred to in Section 6501(a) is the document that provides the information necessary for the Internal Revenue Service to determine the taxpayer's correct income tax liability. See *Germantown Trust Co. v. Commissioner*, 309 U.S. 304, 309-310 (1940) (a fiduciary return filed by a trust company constituted the "return" for purposes of the assessment of a corporate tax because it "disclose[d] all of the data from which the [corporate] tax * * * can be computed"); *Commissioner v. Lane-Wells Co.*, 321 U.S. 219, 222-223 (1944) (timely filing of regular corporate return did *not* commence the running of the limitations period for assessment of the surtax on personal holding companies because

stances, the Court consistently has held that it will "decline to consider [arguments raised] here for the first time." *Demarest v. Manspeaker*, 111 S. Ct. 599, 603 (1991). See also *DeShaney v. Winnebago County Dep't of Social Servs.*, 489 U.S. 189, 195 n.2 (1989); *Berkemer v. McCarty*, 468 U.S. 429, 443 & n.38 (1984).

the corporate returns "did not show the facts on which [surtax] liability would be predicated"). For this reason, in *Automobile Club v. Commissioner*, 353 U.S. 180 (1957), the Court held that informational filings that "lack the data necessary for the computation and assessment of deficiencies * * * are not therefore tax returns within the contemplation of [Section 6501(a)]." *Id.* at 188.

Under these decisions, the return filed by the Subchapter S corporation can not qualify as the "return" that commences the time for assessment of the taxes imposed on individual shareholders. The annual return made by a Subchapter S corporation pursuant to Section 6037 of the Code serves a dual function: (i) it is an "information return" that sets forth detailed information on income and deductions and shows "each shareholder's pro rata share of each item * * * for the taxable year" (26 U.S.C. 6037(a)) to assist in preparation of the individual shareholders' returns; and (ii) it serves as the corporate return reporting taxes owed by the Subchapter S corporation in the limited circumstances in which the corporation may itself be liable for tax. See *Green v. Commissioner*, 963 F.2d at 768-788; *Fehlhaber v. Commissioner*, 954 F.2d at 655; *Benderoff v. United States*, 398 F.2d 132 (8th Cir. 1968); note 2, *supra*. The information contained in a Subchapter S corporation return obviously does not contain all the "data necessary for the computation and assessment" (*Automobile Club v. Commissioner*, 353 U.S. at 188) of the taxes owed by an individual shareholder.¹¹

¹¹ Petitioner misconstrues the decision below in contending (Br. 16-18, 40-41, 44, 51) that the court of appeals held that a Subchapter S corporation's return is not a "return" for purposes of Section 6501 unless a tax is owed by the cor-

The return filed by Compo in this case contained no information relating to petitioner's income, losses or deductions from other sources. It did not indicate his filing status, exemptions or any of the other individualized information required for the calculation of his taxes.¹² Since the information on the Subchapter S return, like the information on a partnership return,¹³ "does not furnish information necessary to calculate the individual[s] income tax," it can not "qualify as the 'return' under § 6501(a) to trigger the statute of limitations for assessment of individual income taxes" (*Siben v. Commissioner*, 930 F.2d at 1036). See also *Estate of Klein v. Commissioner*,

poration. If no tax is owed by the corporation, then there is nothing to assess and Section 6501 has no application. In the unusual circumstances when a tax is owed by a corporation, its return commences the running of the statute of limitations under Section 6501 with respect to the assessment of any "tax imposed" (26 U.S.C. 6501(a)) on the corporation. See *Fehlhuber v. Commissioner*, 954 F.2d at 656. But the return of the Subchapter S corporation cannot constitute the "return" with respect to the "tax imposed" on the shareholder because it does not contain sufficient information to determine the shareholder's liability for tax.

¹² Moreover, the return filed by Compo was for the period ending November 30, 1979, and thus did not even correspond to the same tax period as petitioner's individual return, which was for the year ending December 31, 1979. See J.A. 7, 13.

¹³ See Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 Tax L. Rev. 345, 346 (1984):

Partnerships and now S corporations are the purest forms of pass through entity. They are treated as mere conduits; both undistributed income and losses flow through to their owners and have the same tax character in the owners' hands as they do at the entity level.

537 F.2d 701, 704 (2d Cir.), cert. denied, 429 U.S. 980 (1976); *Durovic v. Commissioner*, 487 F.2d 36, 40 (7th Cir. 1973) ("[t]he filing of an informational partnership return, upon which no assessment can be made within the meaning of 26 U.S.C. § 6501, could not begin the running of the statute of limitations"), cert. denied, 417 U.S. 919 (1974).

The court of appeals was therefore correct in concluding (J.A. 70-73) that the "return" for purposes of the statute of limitations on assessments in Section 6501(a) is that of the taxpayer whose liability is to be assessed and not that of the S corporation, whose return merely contains information on a few of the many items that give rise to the individual taxpayer's liability. Petitioner's contrary contention is not meaningfully different for present purposes from the frivolous suggestion that a W-2 statement filed by an employer that sets forth an employee's wage information constitutes the employee's "return" for purposes of Section 6501. The mere fact that information has been filed with the Service that is *relevant* to the calculation of petitioner's income tax liability does not somehow transform the document containing that information into petitioner's income tax return. See *Siben v. Commissioner*, 930 F.2d at 1035. Nor does it excuse petitioner from making "an accurate report" of his income, including the income he derives from the Subchapter S corporation. *Leonhart v. Commissioner*, 414 F.2d at 750.

B. Section 6037 of the Internal Revenue Code Does Not Allow the Return of the Subchapter S Corporation To Operate as the Return of Its Shareholders

Section 6037 of the Internal Revenue Code requires every Subchapter S corporation to file an annual re-

turn and states, in its last sentence, that “[a]ny return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under Section 6012.” 26 U.S.C. 6037(a). Section 6012, in turn, is the general provision that requires “[e]very corporation subject to taxation” to file a return. 26 U.S.C. 6012(a)(2). The court of appeals correctly held that, under these provisions, when a Subchapter S corporation is itself “required to pay tax, “the filing of an S Corporation return triggers the limitations period for imposition of [the] direct tax against the S Corporation” (J.A. 72). Section 6037, however, has no application to the statute of limitations for assessment of taxes against the shareholders, for the income that “passes through to them is not “subject to taxation” (26 U.S.C. 6012(a)(2)) in the hands of the Subchapter S corporation. Accord, *Green v. Commissioner*, 963 F.2d at 790; *Fehlhaber v. Commissioner*, 954 F.2d at 656-657.

This carefully crafted statutory structure was nonetheless misinterpreted by the Ninth Circuit in *Kelley v. Commissioner*, 877 F.2d 756 (1989). There, the court concluded that Section 6037 should be understood to bar assessment of taxes against both the Subchapter S corporation *and* the shareholders when the three-year period from the filing of the corporate return has expired. The court stated that the scope of Section 6037 is ambiguous and that its interpretation of the statute is preferable because it protects the shareholders from the possibility that their individual liabilities would be assessed after the statute had run on the corporation and its “books and records” had been discarded. 877 F.2d at 758. This reasoning, however, conflicts with the text, the history and the purpose of the statute.

1. a. The language of Section 6037 does not state, or even suggest, that the return of the Subchapter S corporation is to be deemed the return of the individual shareholders for items of income for which the shareholders, rather than the corporation, are “subject to taxation” (26 U.S.C. 6012(a)(2)). Indeed, under this Court’s decisions applying Section 6501, the Subchapter S corporation return cannot constitute the shareholder’s “return” because the corporate return does not contain sufficient information to determine the shareholder’s liability for tax. See pages 14-17, *supra*. By extending the statute to accomplish a result that the text neither requires nor supports, the *Kelley* decision violates the well-established principle that statutes of limitations barring the “collection of taxes otherwise due and unpaid” are to be strictly construed in favor of the Government” (*Badaracco v. Commissioner*, 464 U.S. at 392). See *Fehlhaber v. Commissioner*, 954 F.2d at 657.

For purposes of the statute of limitations, the Subchapter S return constitutes the return of the corporation when—like an ordinary business corporation—the Subchapter S corporation is “subject to taxation” (26 U.S.C. 6012(a)(2)). The legislative history of Section 6037 emphasizes this point (S. Rep. No. 1983, 85th Cong., 2d Sess. 226 (1958) (emphasis added)):

Thus, for example, the period of limitation on assessment and collection of any corporate tax found to be due upon a subsequent determination that *the corporation was not entitled to the benefits of subchapter S*, will run from the date of filing of the return required under the new Section 6037.

If the Subchapter S election is invalid or the corporation otherwise does not qualify for “the benefits of

subchapter S" (*ibid.*),¹⁴ the corporation will be "subject to taxation" (26 U.S.C. 6012(a)(2)) and the assessment of taxes *against it* must be made within three years of its return. Similarly, if a qualified Subchapter S corporation receives the specific types of income for which tax is imposed directly against the corporation (see note 2, *supra*), the period for assessment of that tax "will run from the date of filing of the return required under * * * Section 6037" (S. Rep. No. 1983, *supra*, at 226).¹⁵

As the Second Circuit concluded in this case (J.A. 71-72), however, Section 6037 has no bearing on the limitations period under Section 6501(a) for the assessment of tax for items of income that "pass through" to the individual shareholders of the Subchapter S corporation.¹⁶ Since it is the shareholders,

¹⁴ The qualification requirements for Subchapter S corporations are set forth at 26 U.S.C. 1361. See, e.g., 26 U.S.C. 1361(b)(1) (corporation may have no more than 35 shareholders, all of whom are individuals and are not nonresident aliens); 26 U.S.C. 1361(b)(2) (certain types of corporations are ineligible).

¹⁵ Petitioner is simply wrong in contending that the example provided in the legislative history would "swallow the whole statute" (Br. 52). The Subchapter S corporation is "subject to taxation" (26 U.S.C. 6012(a)(2)) not only when it is not properly qualified (the example given in the legislative history), but also when it earns certain types of income described in 26 U.S.C. 1378 (1976) and when it becomes subject to the "minimum tax." See note 2, *supra*.

¹⁶ Petitioner errs (Br. 38-39) in seeking to draw support from *Siben v. Commissioner*, 930 F.2d at 1036-1037, in which the Second Circuit held that a partnership return does not commence the period for assessment of tax against the individual partners. In *Siben*, the court distinguished *Kelley*, noting that Section 6037 "relating to S corporations

rather than the corporation, who are liable for taxes on these "pass through" items, the statute of limitations for assessing taxes against the corporation is simply irrelevant. The Eleventh Circuit reached this same conclusion in *Fehlhaber v. Commissioner*, noting "[i]t is clear that the last sentence in Section 6037 does not apply to a subchapter S corporation unless its return establishes that the corporation owes a tax." 954 F.2d at 656. See also *Green v. Commissioner*, 963 F.2d at 789-790; *Leonhart v. Commissioner*, 27 T.C.M. (CCH) 443, 462 (1968), *aff'd*, 414 F.2d 749 (4th Cir. 1969) (under Section 6037, the filing of a Subchapter S return begins the period for assessing any tax against the corporation, but does not start the period for making adjustments to items of corporate income or deductions that "pass through" to the shareholders).

b. Congress expressly confirmed this understanding of Section 6037 in enacting the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669. As part of that Act, Congress made the unified auditing provisions that had been established for partnerships by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), 26 U.S.C. 6221

has no counterpart in the partnership provisions" (930 F.2d at 1037). That distinction, however, merely recognizes that *even if Kelley* had properly interpreted Section 6037, that statute has no application to the partnerships that *Siben* involved. When, in this case, the Second Circuit found it necessary to address the effect of Section 6037, the court correctly held that "the 'return' that starts the running of the limitations period at issue is that of the taxpayer whose liability is being assessed, and not that of a third person or entity whose return might also report the transaction that gives rise to the liability." J.A. 70 (citing *Siben v. Commissioner*, 930 F.2d at 1035).

et seq., applicable to certain Subchapter S corporations for years after 1982. See 26 U.S.C. 6241-6245. The Act thus provides for unified treatment of Subchapter S items at the corporate level, rather than examining each shareholder's return separately. See *Fehlhaber v. Commissioner*, 954 F.2d at 657. Under regulations authorized by 26 U.S.C. 6231 that parallel TEFRA's statutory exception from the unified audit procedures for "small" partnerships that have ten or fewer partners (26 U.S.C. 6231(a)), however, the Service has specified that the unified procedures will *not* be applied to the vast majority of Subchapter S corporations (perhaps 95%) that have five or fewer shareholders. Temp. Reg. § 301.6241-1T(c)(2)(ii).¹⁷ The new statute, in any event, applies only to tax years ending after 1982 (see Pub. L. No. 97-354, § 6, 96 Stat. 1697) and thus has no direct application to this case.

With respect to the limited situations to which the new Act does apply, the statute specifies that the period for assessing a shareholder's tax for items that "pass through" from a Subchapter S corporation begins on "the date on which the [corporation's] return for such taxable year was filed" (26 U.S.C. 6229(a)). See 26 U.S.C. 6244. Congress recognized that this new approach—commencing the statute of limitations for assessment of tax imposed against *individuals* with the filing of the *corporate* return—represents a significant departure from the prior law

¹⁷ Since the vast majority of Subchapter S corporations have five or fewer shareholders and will therefore not be subject to the provisions of the new statute, the question presented in this case remains of substantial continuing importance.

that is applicable in this case (S. Rep. No. 640, 97th Cong., 2d Sess. 25 (1982) (emphasis added)):

Under present law, a taxpayer's individual tax liability is determined in proceedings between the Internal Revenue Service and the individual whose tax liability is in dispute. Thus, any issues involving the income or deductions of a subchapter S corporation are determined separately in administrative or judicial proceedings involving the individual shareholder whose tax liability is affected. Statutes of limitations apply at the individual level, based on the returns filed by the individual. The filing by the corporation of its return does not affect the statute of limitations applicable to the shareholders.

The description of "present law" that Congress provided in enacting these related, intertwining modifications to this statutory scheme is "entitled to significant weight." *Seatrail Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. 572, 596 (1980); *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381 (1969).¹⁸ Petitioner's assertion that the period for adjustment of items of income and deductions that "pass through" to an individual from a Subchapter S Corporation

¹⁸ This is not a case in which the views of a subsequent Congress form a "hazardous basis" (*Russello v. United States*, 464 U.S. 16, 26 (1983)) for inferring the meaning of legislation enacted in a prior Session. In enacting intertwining amendments to a statutory scheme based upon a reasonable explanation of existing legislation, the views of the subsequent Congress as to that existing law are expressed in the performance of its legislative function, reflect a particularly well informed understanding of that legislation, and are entitled to great deference. See *Seatrail Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. at 596; *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 275 & n.8 (1974) (citing cases).

that is *not* subject to the provisions of the new Act commences upon the filing by the corporation of its return (Br. 8) conflicts directly with this legislative explanation of "present law." Petitioner's argument thus rests upon the untenable contention that Congress enacted a nullity in establishing new periods of limitation for "pass through" items from a limited category of Subchapter S corporations and that Sections 6229(a) and 6244 were therefore simply unnecessary. See *Fehlhaber v. Commissioner*, 954 F.2d at 656-657.¹⁹

2. The court of appeals also correctly rejected the suggestion of the *Kelley* court that a shareholder of a Subchapter S corporation is powerless to take protective steps to ensure the preservation of corporate records needed to support "pass through" items claimed on the shareholder's return (J.A. 72 (citing *Siben v. Commissioner*, 930 F.2d at 1037)). As the Eleventh Circuit explained in rejecting these "policy" concerns of the *Kelley* court, (i) a construction of Sections 6037 and 6501 that seeks to avoid unfairness to taxpayers conflicts with the court's overriding duty strictly to interpret statutes of limitations that bar the rights of the government to collect taxes otherwise due; (ii) an individual's income tax return is frequently dependent on records maintained by another entity, such as a partnership or trust; and (iii) Subchapter S corporations are, by definition (Section

¹⁹ See also *West Virginia Univ. Hosps., Inc. v. Casey*, 111 S. Ct. 1138, 1148 (1991) ("Where a statutory term presented to us for the first time is ambiguous, we construe it to contain that permissible meaning which fits most logically and comfortably into the body of both previously and subsequently enacted law.") (emphasis added).

1371(a)(1)), owned and operated by a relatively small number of shareholders who have control of and access to the corporation's books.²⁰ *Fehlhaber v. Commissioner*, 954 F.2d at 657-658. See also *Green v. Commissioner*, 963 F.2d at 789.

Petitioner served as the Secretary and Treasurer of Compo (J.A. 14). There is thus no basis for petitioner to suggest that he was unable to take any steps he may have thought necessary to preserve Compo's records concerning the erroneous items that "passed through" to his individual return. Petitioner's concern with hypothetical situations in which a taxpayer may have difficulty obtaining corporate records (Br. 32) cannot be a basis for excusing his liability for tax. As the Fifth Circuit noted in rejecting this same argument in *Green v. Commissioner*, even if the limitations period commenced with the filing of the Subchapter S return, neither the court nor the shareholder could guarantee that the corporation would faithfully preserve its records until the limitations period expired. 963 F.2d at 789. Moreover, as the Eleventh Circuit explained in *Fehlhaber v. Commissioner*, 954 F.2d at 658, "the perceived unfairness to the taxpayer * * * is largely a matter of expecta-

²⁰ For the years in question, a qualifying "small business corporation" could not have more than 5 shareholders. Code Section 1371(a)(1) (1976). Under regulations authorized by Congress as part of the Subchapter S Revision Act of 1982 (26 U.S.C. 6241), the unified audit procedures of the Act are not applicable to Subchapter S corporations that have five or fewer shareholders. See Temp. Reg. § 301.6241-1T(c)(2)(ii). Moreover, each Subchapter S corporation is required to furnish its shareholders a copy of the information shown on the corporate return at their request. 26 U.S.C. 6037(b).

tions." Since the Service has taken a consistent position on this issue at all times, "both taxpayers and S corporations have been on notice that corporate records must be kept for more than three years after the information return is filed." *Ibid.*

In any event, as this Court stated in interpreting Section 6501 in *Badaracco v. Commissioner*, "[c]ourts are not authorized to rewrite a statute because they might deem its effects susceptible of improvement." 464 U.S. at 398. "This is especially so when courts construe a statute of limitations, which 'must receive a strict construction in favor of the Government.'" *Ibid.* (quoting *E.I. du Pont de Nemours & Co. v. Davis*, 264 U.S. 456, 462 (1924)).

Reduced to its essence, petitioner's argument is that he should be subject to *two* different statutes of limitations for each of his tax years—one for his S corporation items and one for the rest of his tax return. This suggestion stems from petitioner's erroneous assumption that, when the Service adjusts the "pass through" items on a shareholder's return and assesses the resulting tax against the shareholder, it is somehow impermissibly adjusting the corporate return as to which the limitations period has expired. But the adjustments and the resulting assessments were made on the shareholder's return, not on the corporation's; the income involved is the shareholder's income, not the corporation's; and the "tax imposed" (26 U.S.C. 6501(a)) is on the individual, not the corporation. It is, of course, true that the corporate return provided information that was relevant to the examination of the shareholder's return. But the statute of limitations upon the "assessment" of petitioner's taxes does not prevent the Service from con-

sidering all relevant information, whatever its source, in making a correct determination of petitioner's taxable income within the period provided.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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